

BEFORE
THE PUBLIC SERVICE COMMISSION OF
SOUTH CAROLINA
DOCKET NO. 95-862-C - ORDER NO. 1999-135
FEBRUARY 18, 1999

IN RE: BellSouth Telecommunications, Inc. –) ORDER
Investigation of Level of Earnings.) ON REMAND
)

✓ MR

This matter comes before the Public Service Commission of South Carolina (the Commission) on remand of our Orders on this BellSouth Telecommunications, Inc. (BellSouth or the Company) earnings review from the South Carolina Supreme Court (the Court). The Court reversed the judgment of the Circuit Court, which had affirmed our Orders on three issues: BAPCO revenue, allowance for cash working capital, and rate of return on common equity. The Court affirmed the Circuit Court's reversal of our holding on Area Plus losses, and affirmed our Orders on annualization of wage and salary expenses.

Accordingly, we have considered the record on appeal in this case, and the oral arguments of counsel for the parties based on that record, and have reached several conclusions, which we elucidate with particularity below.

I. BAPCO REVENUE

In our Order No. 95-1757, the Commission approved the recommendation of the Staff and BellSouth to increase the Company's operating income by \$6,031,000 to reflect the operations of BAPCO {R. at 25}. In his appeal, the Consumer Advocate for the State of South Carolina (the Consumer Advocate), alleged that the Commission's decision was

not adequately documented in findings of fact or supported by substantial evidence. The Supreme Court agreed.

In testimony before the Commission in this case, Consumer Advocate witness Miller testified that the 1994 BAPCO income figure used by the Company and Staff was abnormally low, due to certain non-recurring accounting adjustments which occurred in December 1994 {R. at 317-318}. Miller attached a copy of a Company workpaper which summarizes the determination of BAPCO's 1994 net income to his testimony {R. at 641}. As shown on the workpaper, whereas the average monthly net income for the first eleven months of 1994 amounted to \$551,000, the month of December shows an operating loss of \$25,000. Miller testified that information supplied by the Company in its interrogatory responses showed that this loss occurred because of several "extraordinary" accounting adjustments. These adjustments included additional charges associated with the implementation of SFAS 112 and additional costs associated with the downsizing of the work force as a result of planned technological improvements and new product development efforts {R. at 317-319}. The Supreme Court stated in its opinion that the only conclusion that could be drawn from the record is that those expenses were nonrecurring.

After further examination, we agree that BAPCO expenses were nonrecurring. The object of test year figures is to reflect typical conditions. The Supreme Court has held in prior cases that the Commission should adjust test year data where an unusual situation exists which shows that the test year figures are atypical and thus do not indicate future trends. In this case, the Consumer Advocate proposed normalizing the BAPCO income figure by basing the net income for December on the average for the first eleven

months of the test year. In this manner, the negative income which resulted from extraordinary accounting changes would be eliminated and the test year would be based upon normal operating conditions {R. at 319}. We think that this approach makes sense under the circumstances of this case. Therefore, on remand and reconsideration, we find that the appropriate operating income attributable to the Company from BAPCO is \$6,607,000 {R. at 319}. This figure represents an increase of \$576,000 from the figure approved in our Order No. 95-1757.

II. CASH WORKING CAPITAL

In our Order No. 95-1757, we approved a positive cash working capital allowance for BellSouth of \$2,046,511 based on a methodology that uses the average daily cash balances of the company to determine the requirement. This was the position espoused by the Commission Staff and the Company. In his appeal, the Consumer Advocate alleged that the decision on this issue was inappropriate for several reasons, and the Supreme Court agreed.

Cash working capital is an investment required to support day-to-day operations of a utility, in addition to the utility's investment in plant in service that is used to render service. The level of required investment results because either payments for services, supplies, and other things are made prior to the utility receiving revenues from its customers (positive working capital), or the utility receives payments from its customers before the company has to pay its bills (negative working capital). Although the nature and extent of any working capital requirement will be different for each utility, there will be either a positive or negative working capital requirement for each utility.

In contrast to the position of the Staff and Company, Consumer Advocate witness Miller recommended use of a methodology known as a lead-lag study {R. 327-328}. A lead-lag study empirically identifies the difference in timing between outward cash flow for labor, materials and supplies, inventory, and other expenses, and inward cash flow from charges to customers. In a lead-lag study, revenue lags are computed in terms of the time interval (in days) between provision of service and the collection of revenues associated with the services provided. Expense lags are computed based upon the time interval between the period when the expense was incurred and the date of payment for the expense. If the revenue lag exceeds the expense lag, then a positive cash working capital requirement results. If the expense lag exceeds the revenue lag, then a negative cash working capital requirement results. Miller presented an attachment to his testimony which showed the results of a lead-lag study conducted for BellSouth in 1993 and updated for 1994. Hearing Exhibit 17, Attachment 8 {R. 643-646}. Miller recommended setting the requirement at zero, based on the finding of this study that BellSouth had a negative requirement. {R. 326-330}; and Hearing Exhibit 17 PEM-2 {R. 649}.

After reconsideration, we find that the record in this particular case contains testimony which shows that the lead lag study is the more accurate, detailed, and appropriate methodology to compute the cash working capital requirement for this utility in this case. The record also shows that the results of this particular BellSouth lead-lag study shows a negative cash working capital requirement. Further, since 85% of local service revenues are collected thirty (30) days in advance according to the record, there is a negative working capital requirement {R. 329-330}.

Therefore, upon reconsideration of the cash working capital adjustment in this case, and the admonitions of the Supreme Court, we find that a fair balance would be to set the cash working capital requirement for BellSouth at zero. This will eliminate \$2,046,511 from the Company's rate base, resulting in an intrastate rate base for South Carolina of \$959,944,082.

III. AREA PLUS LOSSES

In our Order No. 95-1757, the Commission approved the Staff's proposed adjustment of \$4,482,300 to BellSouth's revenues, to account for projected losses from the Company's offering of Area Plus service. In Docket No. 93-176-C, which examined the approval of the service, the Consumer Advocate contended that BellSouth should not be able to recognize this foregone toll revenue as an adjustment to its reported revenues for ratemaking purposes, on the grounds that the Company's other customers should not be forced to subsidize the Company's losses from Area Plus. After the initial Commission Order in Docket No. 93-176 was appealed by several parties to the Circuit Court, that Court remanded the case back to the Commission for the purpose of taking additional evidence on December 3, 1993. On remand, the parties reached a Stipulation resolving all outstanding issues {R. 88}. In our Order No. 94-342, this Commission approved the Stipulation, finding that it was in the public interest, and that it would increase competition in the intraLATA market in South Carolina. Paragraph 10 of the Stipulation provided that BellSouth would not come before the Commission requesting rate relief for any possible losses resulting from the introduction of Area Plus Service, the execution of the Area Calling Plan Principles Agreement, or the Stipulation. Based on

our approval of this Stipulation, the parties executed a Consent Order of Dismissal, which settled the appeals of the Area Plus case.

In approving the Staff's adjustment for Area Plus losses, we held that since BellSouth had not "come before the Commission requesting rate relief," but had been required to appear before the Commission for an earnings review, that that particular term of the Stipulation did not apply. Both the Circuit Court and the Supreme Court disagreed with that holding, and held that the term should apply, even under an "earnings review" docket. Accordingly, since two courts have now clearly outlined their disagreement with our original Orders, on remand and reconsideration, we hereby eliminate the negative adjustment of \$4,482,300 to BellSouth's revenues resulting from the offering of Area Plus, and hold that that particular term of the Stipulation as regards Area Plus losses applies to this earnings review as well as the circumstance when the Company actually comes before the Commission seeking rate relief for Area Plus losses.

IV. RATE OF RETURN ON EQUITY

In our Order No. 95-1757, we found that the appropriate rate of return on equity used to establish rates for BellSouth was 12.75% {R. 48}. The Consumer Advocate appealed this holding on several grounds, but the Supreme Court found only that the Commission's decision on this issue was not adequately documented in the findings of fact, nor was our conclusion adequately explained. That Court reminds us that statutes and Court precedent require an administrative agency to make specific findings of fact and explain our rationale in sufficient detail to afford judicial review. By way of explanation, we certainly did not believe that we were issuing our prior Orders in this case with inadequate findings and explanations of our conclusions. In fact, we thought we

had stated an appropriate basis for our findings under the law at the time our Orders were written. However, we recognize that the Supreme Court has ordered a clearer and more detailed explanation of the rationale for our holding. We will provide that explanation herein. After a careful review of the evidence in this case, we reaffirm our prior holding that 12.75% is the appropriate rate of return on equity for BellSouth Telecommunications, Inc. Our reasoning follows.

In determining the fair return on common equity, the Commission has been guided by the principles set forth in Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 602 (1944); Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679 (1923), and Southern Bell Telephone and Telegraph Company v. South Carolina Public Service Commission, 270 S.C. 590, 244 S.E. 2d 278 (1978). Essentially, these cases require that the return on common equity set by the Commission be commensurate with returns on investments or enterprises with similar risks; that the return is adequate to ensure the confidence of the financial markets; and that it is sufficient to allow a company to maintain its creditworthiness, and to allow it to attract capital as needed on reasonable terms. Virtually all of the cost of capital witnesses appearing in this case make reference and subscribe to these guidelines.

The Commission finds that one of the critical inquiries in establishing the appropriate cost of equity is what return will investors reasonably likely require in the future before they invest in a utility or any other business. Because this Commission's task is to establish a rate of return that investors are reasonably likely to require in the future, we find that it is appropriate to utilize the most objective, representative measure

of investors' long-term growth expectations. Because investors use analysts' overall growth rate forecasts in valuing equity securities, a survey of analysts produces the most objective measure of those expectations.

We find that investors are forward looking and that investment decisions are made on the basis of how investors expect a stock to perform in the future. A stock's past performance may influence an investor's expectations concerning future performance, but there is no guarantee that the future will be an extension of the past. Therefore, it is important that estimated growth rates should be measured prospectively, not historically.

A second critical inquiry in this proceeding is the selection of a surrogate group. BellSouth of South Carolina is not a publicly traded Company. Therefore, a proxy or surrogate has to be used to determine an estimate of BellSouth of South Carolina's cost of equity for its telephone operations. The need for a surrogate is not in dispute among the three cost of capital witnesses in this case. Each witness offered some other publicly traded company or group of companies which purportedly could be used to represent BellSouth. Dr. John Legler and Dr. James Spearman chose to compare only telephone companies. Dr. Randall Billingsley offered two groups for comparison purposes: first, a group of utility and non-utility companies, and, second, a group of Regional Bell Holding Companies (RBHCs) and independent telephone companies.

Under the facts of this case, we find that RBHCs and independent telephone companies are the appropriate surrogate or proxy group. Under different facts, such as under a fully competitive environment, companies other than telephone companies may be appropriate as a surrogate group. However, even though we acknowledge that the telecommunications industry has increased dramatically in recent times, we have not

heretofore held that BellSouth operates in a fully competitive environment. Therefore, we hold that the use of RBHCs and independent telephone companies is appropriate as a surrogate group for BellSouth for this proceeding.

The three cost of capital witnesses used similar methods for estimating the cost of capital. Each used some variation of a discounted cash flow method (DCF) and a risk premium approach. The principal differences in the results reached by the three witnesses were largely based on the surrogate group selected, and the data sources they selected for their particular analyses. We specifically point out that the rebuttal testimony of Dr. Billingsley analyzed the RBHCs and independent telephone company comparison group. Using his DCF and Capital Asset Pricing Model (CAPM) methodologies and Institutional Brokers Estimate Service (IBES) and ZACKS Investment Research (ZACKS) to determine future growth, Dr. Billingsley calculated that the cost of equity would lie between 12.23% and 15.00%, with a mid-point of 13.62% {R. 465}. Billingsley's use of IBES and ZACKS is consistent with our belief that broad analysts' survey services such as these two services are consistent with the approach that a survey of analysts produces the most objective measure of investors' long-term and forward looking growth expectations.

Further, Billingsley reworked Legler's CAPM analysis using BARRA betas instead of Value Line betas. BARRA betas are adjusted to provide more forward-looking betas than the Value Line historical betas employed by Legler. The testimonies presented by Drs. Legler and Spearman fail to take into account forward looking growth expectations, since the methodologies employed do not use IBES, ZACKS, BARRA betas, or their equivalents. More specifically, Billingsley estimates the DCF cost of

equity for the RBHCs to be 12.63% using IBES growth rates and 12.84% using ZACKS growth rates with a midpoint of 12.74%. Billingsley's CAPM estimate of BellSouth's cost of equity is between 12.64% and 12.85%, using his methodology {R. 464-465}. Further, Hearing Exhibit 23, Billingsley's rebuttal exhibit is particularly noteworthy {R. 691}. This exhibit summarizes his DCF and CAPM cost of equity estimates for the RBHCs and a group of independent telephone companies. If one averages the DCF and CAPM results for both groups of telephone companies together, Billingsley's numbers indicate a range of returns on equity between 12.75% to 13.87%. Although these numbers do not appear in the Exhibit itself, a simple mathematical calculation averaging the numbers from the Exhibit yields these results. We believe that averaging the RBHCs and the independent telephone companies together is an appropriate way to show the overall picture of the cost of equity, since an average figure shows a clear picture of the combined costs of the two groups of telephone companies.

We state again that we believe that a 12.75% rate of return on equity, the low end of this range, is the appropriate rate of return on equity for BellSouth Telecommunications, Inc. We think that this number appropriately represents a reasonable expectation for the equity owner, and meets the other tests set out in the Bluefield Water Works, Hope, and Southern Bell cases, (i.e., is commensurate return with investments of comparable risk, sufficient return to maintain Company's credit standard and the ability to raise capital, reflection of changing economic conditions, etc.) while not overcompensating the Company. In short, we believe that 12.75% represents a good balance between the interests of the ratepayers and the interests of the Company.

We hold that this number does not recognize issuance or flotation costs, and that such costs should not be considered in the present case. Recognition of such costs is only appropriate when a company has recently issued or plans to issue additional stock during the time period in which the rates resulting from the case are expected to be in effect. BellSouth's South Carolina affiliate does not issue stock, and BellSouth had no public offering of stock since its last rate case. Nor did BellSouth anticipate any public issuance of stock at the time of the Hearing. (See Spearman testimony at R. 291.)

Based on the above-stated reasoning, we hold that 12.75% is the appropriate rate of return on equity for the Company. This is the lowest cost of equity that can be achieved using a telephone company-based surrogate group and consensus forward-looking estimates of growth and market returns. The Commission also finds that 12.75% is the lowest cost of equity that can be determined for BellSouth based on the principles articulated by the United States Supreme Court in the Bluefield and Hope cases, by the South Carolina Supreme Court in the Southern Bell case, and by the other requirements of South Carolina law.

In Order No. 95-1757, we stated that we did not agree that the surrogates used by Dr. Legler and Dr. Spearman were inappropriate. We find that the surrogate companies used by these two witnesses and by Dr. Billingsley in his rebuttal testimony are appropriate in this proceeding. In Order No. 95-1757, we were attempting to show that we had considered all the evidence which included all types of companies. We have reviewed the results of each witnesses' analysis which used different types of companies and which applied different methodologies to each type. It is only after reviewing and analyzing all the evidence that we conclude that telephone companies are the appropriate

surrogate under the particular facts of this case. The cost of equity of 12.75% represents a reasonable expectation of the investor and will result in rates that are not higher than necessary to give a fair rate of return to BellSouth shareholders. The resultant appropriate overall rate of return is 10.86%, which may be calculated using the rate of return on equity figure in the appropriate formula.

V. CONSUMER ADVOCATE'S OBJECTION

At the December 15, 1998 oral argument before the Commission, the Consumer Advocate raised an objection to the argument on the grounds that the Supreme Court had not specifically provided for further proceedings in its opinion in this matter. We note that the only matter not resolved above in the manner suggested by the Consumer Advocate is our holding on rate of return on equity. Even so, we do not believe that holding oral arguments as to the proper implementation of the Supreme Court's opinion, is a "proceeding" held in violation of the directions of the Court. We note that the Court mentions in its opinion the case of Parker v. South Carolina Public Service Commission, 288 S.C. 304, 342 S.E. 2d 403 (1986), which prohibits an administrative agency from considering additional evidence upon remand unless the Court allows it (emphasis added). We would note that the oral arguments in this case considered no new evidence. The parties merely argued their interpretation as to how the Supreme Court opinion should be implemented, based on the record in the case. We discern no violation of any Court precept. The Consumer Advocate's objection must therefore be overruled.

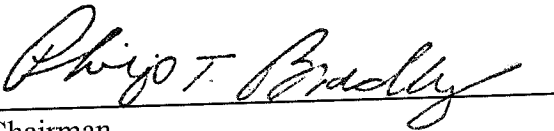
VI. REFUNDS AND RATE REDUCTIONS

We realize that the above-stated conclusions require the granting of relief, either in the form of refunds and/or prospective rate reductions. We hereby establish a

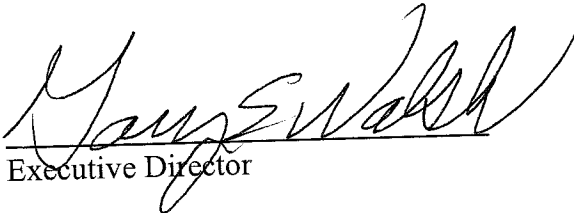
proceeding in this matter to determine what rate relief may be granted, i.e. refunds and/or prospective rate reductions, and to what ratepayers. A hearing shall be held at **10:30 AM on April 15, 1999** in the offices of the Commission for this purpose. Testimony and/or exhibits shall be prefiled on this matter by any party who wishes to do so on or before **April 1, 1999**. The parties are reminded that all testimony and/or exhibits must be served on all other parties to this Docket.

This Order shall remain in full force and effect until further Order of the Commission.

BY ORDER OF THE COMMISSION:


Chairman

ATTEST:


Executive Director

(SEAL)